



INSPECTOR GENERAL REPORT

2006-06-0206

August 22, 2007

STATE LOTTERY COMMISSION

Inspector General David O. Thomas and Staff Attorney Amanda Schaeffer, after an investigation by Special Agent Darrell Boehmer and the State Board of Accounts, report as follows:

The Office of Inspector General (OIG) and the State Board of Accounts (SBOA), through a joint investigation, address several State Lottery Commission (Lottery) expenditures.

I.

Investigation

Investigating the activities of the Lottery is challenging because of its unique statutory structure.

The Indiana Legislature created the Lottery like no other entity in state government, making the Lottery a “separate body politic and corporate from state government” to “function as much as possible as an entrepreneurial business enterprise.” IC 4-30-1-2(1).

This statutory directive goes on to state: “[T]he general assembly recognizes that the operation of a lottery is a unique activity for state government and that *policies and procedures appropriate for the performance of other*

governmental functions are not necessarily appropriate for the operation of a lottery [emphasis added].” IC 4-30-1-2(2).

The Legislature also directs that the Lottery, unlike most state entities, “be operated as a self-supporting revenue raising operation.” IC 4-30-1-2(3).

To accomplish these unique duties, the Lottery is exempted from state procurement rules, providing the Lottery the freedom to formulate its own rules on how it purchases materials and services. IC 4-30-8-1; IC 4-30-8-9; IC 5-22.

Furthermore, the Lottery is exempt from the daily deposit requirement in IC 5-13-6-1 on the funds it receives. IC 4-30-10-1; IC 4-30-16-3.

We find no other legislative state entity with this combined, unique structure.

In June of 2006, the OIG received two anonymous complaints (complaint) regarding the Lottery. Copies of one of these anonymous complaints were sent to various governmental agencies and media outlets and substantial media coverage followed.

These anonymous complaints alleged that unethical behavior and mismanagement was occurring within the Lottery. Specific allegations are addressed below.

OIG Special Agent Darrell Boehmer was assigned and an investigation commenced. The SBOA also agreed to perform auditing functions during the course of the investigation. Multiple persons were interviewed, including the Executive Director at that time, Esther Schneider (Director). Subpoenas were issued and numerous financial and contractual documents were extensively reviewed.

The SBOA also conducted its separate audit of the Lottery pursuant to IC 4-30-19-2 near the conclusion of this investigation. A concluding exit conference with the former Director, the State Examiner, SBOA auditors, a commission member of the Lottery and the Inspector General subsequently occurred. A final written response was issued by the Lottery thereafter, and a concluding meeting with the current Lottery management occurred on August 7, 2007.

II.

Jurisdiction

The OIG enabling statute states that the OIG “is responsible for addressing fraud, waste, abuse and wrongdoing in agencies”. IC 4-2-7-2(b). The OIG is to conduct investigations and “recommend policies and carry out other activities designed to deter, detect, and eradicate fraud, waste, abuse, mismanagement, and misconduct in state government”. IC 4-2-7-3(2). The OIG is also charged to investigate matters which may violate the Indiana Code of Ethics. IC 4-2-7-3(3).

The definition of “agency” includes “a body corporate and politic established as an instrumentality of the state”. IC 4-2-7-1(1).

Prior to the creation of the OIG in 2005, quasi-agencies like the Lottery could decline being subject to the Code of Ethics. The OIG enabling statute, however, took away this discretion and made quasi-agencies subject to the Code of Ethics.¹

Accordingly, the OIG has jurisdiction to investigate the Lottery regarding

¹ IC 4-2-6-1(a)(2).

these allegations.

III.

Findings and Recommendations

Preliminarily, the unique structure of the Indiana Lottery may be supported by the results produced by the Lottery. Fiscal year 2006 demonstrates that the Lottery transferred to the state treasury, after its operating expenses, over \$209 million dollars in revenue, much of this going to local police and fire pensions and the Teacher's Retirement Fund.² Comparable Lottery transfers to the state treasury also occurred in fiscal years 2005 and 2004.

However, no one doubts that there must be a standard of conduct for the employees of the Lottery which balances these results of financial profits with what the Legislature and public expects for accountability. Although empowering the Lottery to seek maximum profits, the Legislature has not endorsed unfettered conduct in this pursuit, and states: "The director shall operate the lottery to maximize revenues in a manner consistent with the dignity of the state and the welfare of its citizens." IC 4-30-5-3.

Fundamental fairness also demands that the employees of the Lottery have clear direction on what is expected of them with this duty and challenge of running the Lottery to seek maximum profits and yet satisfy public scrutiny.

With these legislative directions in mind, the OIG makes the following findings and recommendations:

² *Report on Distribution of BIF and Riverboat Admissions and Wagering Taxes*, Indiana State Budget Agency, page four.

A.

The OIG agrees with and adopts the SBOA findings which are attached hereto as Exhibit A.

A natural consequence of these findings is that the SBOA manual³ applies to Lottery operations.⁴

B.

The OIG also addresses other allegations in the complaint and makes the following additional findings and recommendations, many addressing the Code of Ethics.⁵

1.

The anonymous complaint alleged an ethics violation for political activity,

³ The SBOA conducts its audits for state agencies using the written standards in its “Accounting and Uniform Compliance Guidelines Manual for State Agencies” (SBOA Manual).

⁴ The SBOA audit of the Lottery is required by IC 4-30-19-2, which states that the “state board of accounts shall conduct an annual audit of the operations of the lottery” in addition to private vendor audits permitted by the statute. Prior to 2005, the statute stated only that the Lottery was “subject to” an audit by the SBOA and did not require an annual audit. However, IC 4-30-19-2 does not articulate which rules or regulations the SBOA is to use as a standard in its audit. Furthermore, IC 5-11-1-2 states the SBOA “shall formulate, prescribe, and install a system of accounting and reporting in conformity with this chapter, which must... be uniform for every public office and every public account of the same class and contain written standards that an entity that is subject to audit must observe.” It is logical that the SBOA manual applies to the Lottery if the SBOA is statutorily charged to perform this audit and because this SBOA audit is in addition to the private vendor audit required in the statute.

⁵ Ethics investigations are confidential unless the State Ethics Commission determines probable cause exists for a violation or if the respondent waives confidentiality. Here, the former Director has stated publicly and in different public forums that she would welcome an investigation into these allegations, thereby waiving confidentiality.

but the investigation, which included multiple interviews and document examinations, did not reveal evidence that the former Director engaged in political activity in violation of 42 IAC 1-5-4. This rule states in relevant part that a special state appointee, such as the Director, shall not engage in political activity while on duty or while acting in an official capacity. No one interviewed indicated that the Director had conducted such activity while on duty or while acting in her official capacity as Director.

During the investigation of this allegation the OIG also reviewed Lottery funds used to sponsor a Richard Lugar's "Excellence in Public Service" series. The mission of this entity as alleged in its website is "to increase the number and influence of Hoosier Republican women in elected and appointed governmental and political positions at the local, state and federal levels." The Director indicated that this was done for advertising purposes because market research suggested that women within the demographic of those who are part of the "Excellence in Public Service" series may be likely to buy lottery tickets, and therefore the Director thought advertising at this event would be effective.

While this expenditure is challenged as inappropriate by the OIG, it does not rise to the level of an ethics violation because "political activity" as addressed in 42 IAC 1-5-4 generally refers to activity in support of a candidate in a pending election. Even with the legislative recognition "that the operation of a lottery is a unique activity for state government and that policies and procedures appropriate for the performance of other governmental functions are not necessarily

appropriate for the operation of a lottery”,⁶ the OIG recommends that such expenditures, even if for advertising purposes, should not reoccur.

2

The anonymous complaint next indicated that the Director had accepted items or entertainment from vendors, thereby implicating the gift rule in 42 IAC 1-5-1. However, the investigation indicated that that these items were provided pursuant to a Lottery administrative rule in 65 IAC 2-1-14(d) which states that “[Lottery] contract may provide for the reimbursement of direct, out-of-pocket costs for travel and subsistence expenses.”

This administrative rule under 65 IAC 2-1-14 was promulgated before the Lottery became subject to the Code of Ethics in 2005, and appears to be less restrictive than the gift rule in 42 IAC 1-5-1. Because the Code of Ethics in 42 IAC 1-6-1 states that “an appointing authority of an agency or a state officer may adopt policies, rules, or regulations concerning the subject matter of this rule provided that the policies, rules, or regulations are at least as strict as this rule,” the OIG accordingly recommends that the Lottery review all of its administrative rules for consistency with the Code of Ethics.

3

The complaint also alleged the Code of Ethics was violated by entertainment expenditures by the Lottery. The audit of the Lottery revealed expenses that could be classified as entertainment, but the audit did not reveal any

⁶ IC 4-30-1-2.

expense reports that appeared to be false or improperly submitted, as alleged by the complaint. These entertainment expenses are addressed in the SBOA report (Exhibit A). While this use of Lottery funds is questioned both by the SBOA and OIG, no use of these funds qualifies as an ethics violation because this use has been authorized by the Lottery in a written policy as required for compliance with the Code of Ethics. Specifically, the Lottery has a written policy which states that certain employees are authorized to incur “business-related entertainment expenses” with the Department Director’s permission.

4

Investigators also examined in detail contracts that were awarded through the Lottery, specifically contracts that were alleged in the complaint to have been awarded to “favor friends, former business partners and political associates.” A contract between the Lottery and a former business associate of the Director, John Marz, was examined. This was a professional services contract which required Marz to perform sales and marketing research for the Lottery. This contract was not required under law to go through a Request for Proposals (RFP) procedure because the contract was for professional services. The administrative rule in 65 IAC 2-1-3(a)(7) falls under the Lottery’s procurement rules and states that the internal Lottery rules for procurement apply to all contracts for the procurement of goods or services except “contracts for personal or professional services.” Furthermore, 65 IAC 2-4-1 states that “the director may procure all goods and services not otherwise covered by this article in any manner in which the director deems desirable.” In addition, market research by the Lottery is mandated under

IC 4-30-3-6. Accordingly, there is no evidence that awarding the contract to Marz for professional services violated the state's ethics laws.

5.

The complaint also alleged an ethics violation in the funding of equestrian events by the Lottery. The Lottery contends these expenditures were for advertising purposes. The thrust of this complaint was the allegation that the Director benefited in some way by personally having a horse entered in the equestrian event at the time that the equestrian event was sponsored by the Lottery. Her interview revealed that she had participated in these events, but not in the years of the sponsorships. No personal gain is evident.

Again, not only does IC 4-30-1-2(2) state that "the operation of a lottery is a unique activity for state government and that policies and procedures appropriate for the performance of other governmental functions are not necessarily appropriate for the operation of a lottery," the Lottery Director is also given broad discretion under law to utilize Lottery funds for advertising. IC 4-30-8-1(b); IC 4-30-1-2; 65 IAC 2-4-1.

6

The complaint also alleged an ethics violation for the manner in which the new cash bonus system instituted by the Director was operated. However, the system implemented by the Director actually resulted in a lower cash bonus to the Director than under the previous system, and it provided for less discretion and more stability in who received cash bonuses and the amount received. Therefore,

no ethics violation for misuse of funds was found with regard to the cash bonus system.

7

The anonymous complaint also alleged that the Director directed staff members to perform personal errands for her while on duty. The Code of Ethics in 42 IAC 1-5-13 requires that only official duties be performed or assigned.

Interviews determined that, on one occasion, the Director brought her dogs to the office, but did not ask any employee to care for the dogs. No employee interviewed could recall being asked to perform improper personal services for the Director.

8.

Lastly, the OIG found that contractor billings submitted to and paid by the Lottery for the personal service contract with John Marz were not itemized as required by IC 5-11-10-1(b) and IC 4-10-12-1. Although not a violation of the Code of Ethics, the OIG recommends, from an efficiency standpoint, that future personal service contract billings be itemized prior to Lottery payment for better accountability.

Dated this 22nd day of August, 2007.



David O. Thomas, Inspector General

STATE BOARD OF ACCOUNTS
302 West Washington Street
Room E418
INDIANAPOLIS, INDIANA 46204-2769

REVIEW REPORT
OF
THE STATE LOTTERY COMMISSION OF INDIANA
July 1, 2005 to June 30, 2006

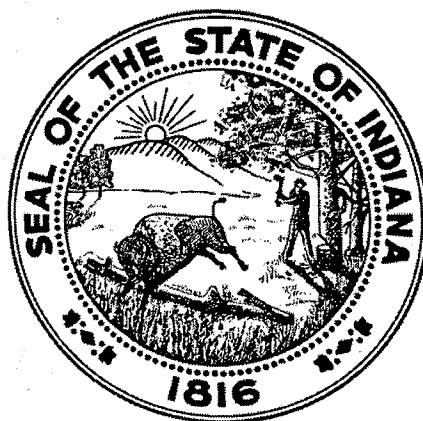
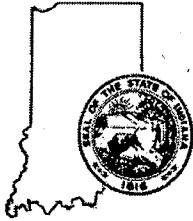


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AGENCY OFFICIALS

<u>Office</u>	<u>Official</u>	<u>Term</u>
Director	Esther Q. Schneider Kathryn Densborn	07-01-05 to 12-06-06 12-07-06 to 01-11-09
Chairman of Commission	Jean Northenor	07-01-05 to 06-30-08



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INDEPENDENT ACCOUNTANT'S REPORT

TO: THE OFFICIALS OF THE STATE LOTTERY COMMISSION OF INDIANA

We have reviewed the compliance with laws and regulation of The State Lottery Commission of Indiana for the period of July 1, 2005 to June 30, 2006. The State Lottery Commission of Indiana's management is responsible for the compliance with laws and regulations.

Our review was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. A review is substantially less in scope than an examination, the objective of which is the expression of an opinion on the receipts, disbursements, and assets. Accordingly, we do not express such an opinion.

The financial statements of The State Lottery Commission of Indiana for the period July 1, 2005 to June 30, 2006 were audited by other auditors. This financial statement report is on file in our office as a public record.

Based on our review, nothing came to our attention that caused us to believe that laws and regulations of The State Lottery Commission of Indiana are not in all material respects in conformity with the criteria set forth in the Indiana Code and policies and procedures established by The State Lottery Commission of Indiana, except as stated in the review comments.

STATE BOARD OF ACCOUNTS

April 12, 2007

THE STATE LOTTERY COMMISSION OF INDIANA
REVIEW COMMENTS

INAPPROPRIATE USE OF LOTTERY FUNDS

During our review of the State Lottery Commission of Indiana (Commission), we found numerous payments for items that are considered personal in nature and an inappropriate use of lottery funds.

Meals

The Commission paid for lunches and dinners that appeared to be attended by only Commission employees who were not in travel status. Some of these meals may have been attended by Commission vendors or retailers but documentation did not indicate the attendees. Meals for Commission employees not in travel status are considered personal in nature.

Documentation of attendees should be provided with all meal purchases to support the business nature of the meals.

Mementos and Flowers

The Commission paid for mementos and flowers for retirement, maternity, get well soon, and sympathy occasions. These purchases are considered personal in nature.

Inappropriate Party Purchase

The Commission paid \$525.00 for a disc jockey at a party attended only by Commission sales staff. This expenditure is a questionable use of Lottery funds.

Lottery funds should not be used to pay for personal items or for expenses which do not relate to the functions and purposes of the Commission.

DONATIONS

The Commission made two \$5,000 donations to the Richard Lugar's "Excellence in Public Service Series." The Commission also paid \$130 for employees to attend the "Excellence in Public Service Series" lunch.

The "Excellence in Public Service Series" mission is "to increase the number and influence of Hoosier Republican women in elected and appointed governmental and political positions at the local, state and federal levels."

THE STATE LOTTERY COMMISSION OF INDIANA
REVIEW COMMENTS
(Continued)

LACK OF TICKET ACCOUNTABILITY

The Commission purchased some of its advertising through sponsored events. As part of the sponsorship packages the Commission often received tickets and other perks related to the sponsored events. They also purchased Pacer season tickets. The Commission could not provide adequate accountability for the distribution of all the perks and tickets received.

All perks and tickets received should be properly accounted for to ensure that Commission employees did not personally benefit from these items. Tickets or other perks obtained from purchases with Lottery funds and used by Commission employees may be considered additional compensation and/or an ethics violation.

65 IAC 1-4-3 (b) states: "A member, officer, or employee shall not accept any form of compensation other than from the commission for any services rendered as part of the member, officer, or employee's official duties for the commission."

65 IAC 1-4-5 (a) states: "Members, officers and employees shall not directly or indirectly request or accept any gift, favor, service, loan, or entertainment for themselves or others under circumstances that might reasonably be construed to influence the performance of their official duties for the commission."

Each agency, department, institution or office should have internal controls in effect which provide reasonable assurance regarding the reliability of financial information and records, effectiveness and efficiency of operations, proper execution of management's objectives, and compliance with laws and regulations.

ATTENDANCE REPORTS

We observed that employee attendance reports were frequently signed and dated prior to the last day worked.

Employee attendance reports should not be signed, dated or approved prior to the last day worked in a pay period.

**THE STATE LOTTERY COMMISSION OF INDIANA
EXIT CONFERENCE**

The contents of this report were discussed on April 12, 2007, with Esther Q. Schneider, former Director. The official response has been made a part of this report and may be found on page 7.

The contents of this report were discussed on April 23, 2007, with Kathryn Densborn, Director; W. Edward Benton, Chief Financial Officer; Tim Kuehr, Controller; and Carrie Stroud, Internal Auditor. The official response has been made a part of this report and may be found on pages 8 through 10.

26 July 2007

TO: State Board of Accounts

FR: Esther Q. Schneider
Hoosier Lottery Executive Director
January 2005 – January 2007

RE: Response to the State Board of Accounts' Hoosier Lottery 2005-06 Audit

The Hoosier Lottery has conducted outside financial audits since its inception in 1989. The Legislature took action after a 2004 internal security breach allowed the disclosure of the location of a winning \$1 million scratch-off ticket. Prior to legislative action, the Lottery, being a quasi state agency, was not subject to State Board of Accounts' audit until now. Since that action in 2005, State Board of Accounts audits have been required and have been performed.

I firmly believe that such audits serve the best interests of the public, helping to create the transparency of all Hoosier Lottery operations. The findings attached clearly indicate that there are compliance rules and procedures that have not been followed and that corrective action needs to be taken immediately, up to and including the training of all Hoosier Lottery staff on all applicable Indiana State rules for operation.

Since its inception more than 17 years ago, the Lottery has had a minimum of one attorney on staff at all times as well as an internal auditor. None of the stated infractions has ever been identified as being illegal practices and/or areas requiring greater disclosure. Upon my arrival in January of 2005, I noticed a lack of documentation in many areas of the Lottery and implemented more stringent reporting practices. However, this report clearly indicates a serious need for compliance training in all departments of the Lottery. As further evidence for the need for compliance training, the Lottery had utilized retailers' social security numbers for 17 years as a means to conduct background checks for Lottery retailer licenses. At no time has the Hoosier Lottery had statutory authority to mandate that Hoosier Lottery retail applicants supply their social security numbers. Yet, this illegal practice was identified only after changes to the retailer license application were requested and the Indiana State Attorney Generals Office began serving as the Lottery's counsel in early 2006.

Given that the Hoosier Lottery is a quasi state agency and operates unlike any other state agency, I believe it would be most helpful if the State Board of Accounts were to conduct compliance training, requiring the participation of key Lottery staff. This training should include the review of all of the rules, policies and procedures that apply specifically to the Hoosier Lottery.

In closing, I believe that the Hoosier Lottery should continue to conduct various and regular audits in all departments as this will help to strengthen and improve the Hoosier Lottery's credibility with the players, the Indiana Legislature and the public.

HOOSIER LOTTERY

June 27, 2007

Bruce A. Hartman, State Examiner
Indiana State Board of Accounts
302 West Washington Street
4th Floor, Room E418
Indianapolis, IN 46204-2765

Dear State Examiner Hartman:

Please see the attached responses to the revised audit review comments by the Indiana State Board of Accounts Auditors. Should you have any questions or need additional clarification, I can be reached at 317-264-4961 or ebenton@hoosierlottery.com.

Sincerely,



W. Edward Benton
Chief Financial Officer

Encs.

cc: Al Marshall, State Board of Accounts
Kathryn Densborn, Executive Director, Hoosier Lottery
Tim Kuehr, Controller, Hoosier Lottery
Carrie Stroud, Internal Auditor, Hoosier Lottery

THE STATE LOTTERY COMMISSION OF INDIANA

Responses to the audit review comments as
submitted by The Indiana State Board of Accounts

Revised for updated comments received 6-27-07

INAPPROPRIATE USE OF LOTTERY FUNDS:

The State Lottery Commission of Indiana was established as a body politic and corporate separate from the State of Indiana. The Indiana State Lottery Act recognizes that "the policies and procedures appropriate for the performance of other governmental functions are not necessarily appropriate for the operation of a lottery." Ind. Code 4-30-1-2 (2). The Lottery is directed to "function as much as possible as an entrepreneurial business enterprise." Ind. Code 4-30-1-2 (1).

Meals:

The meals identified are infrequent and of a normal business nature. Expense vouchers for meals have listed the persons at such lunches or dinners but frequently did not further identify who these people represented. Our expense reimbursement policy now requires that we identify the persons attending such meals and the company or internal department which they represent. Lottery personnel attending such business lunches or dinners may not always be in travel status but are persons who would be expected to attend under normal business conditions and such expenses would normally be reimbursed by a business enterprise.

Mementos and Flowers:

Payments for mementos and flowers are both closely monitored and minimal. We feel that paying for flowers for bereavement or small mementos for retirement constitute both normal and good business practices. We feel that these small expenditures fall under both the aforementioned Indiana Lottery Code and under the Lottery's administrative code that authorizes the Director to exercise authority and powers that are customarily exercised under Indiana law by the chief executive and operational officer of an entrepreneurial business enterprise.

Inappropriate Party Purchase:

The Hoosier Lottery sales staff is essential to generating revenue. The Hoosier lottery, as other sales oriented businesses, holds regular sales meetings and has a sales incentive plan. The specific instance mentioned here was for an evening function following our annual sales conference. We feel this small expenditure is of a sales incentive nature and is in line with building morale and camaraderie within our diverse sales force. We certainly do not agree that it is a questionable use of lottery funds or that it does not relate to functions and purposes of the Commission.

LACK OF TICKET ACCOUNTABILITY:

Earlier this year a new policy was instituted whereby all perks or tickets from sponsorships are delivered to and controlled by one person who records receipt and disbursement of such tickets. Our Internal Auditor will monitor adherence to such policy. Previously, such tickets were received and distributed by the various departments such as Sales, Marketing or Public Relations.

ATTENDANCE REPORTS:

Exempt lottery employees are only required to submit attendance reports when they have used vacation or personal time off. Occasionally, a report will be signed and turned in prior to the end of a pay period when the employee knows that they will be out on vacation or personal time on the day that such report is due. In other instances field associates may submit their reports on a Thursday evening or Friday morning of a reporting period to facilitate our payroll system reporting. When someone does not work on the particular Friday, the supervisor will call and fax a new report. We are working with our payroll department and payroll processor to change the reporting time so that the reports may be submitted on Mondays.